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RELEASED

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9 The Honorable Les Aspin
House of Representatives

K Dear Mr. Aspin:

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In your letter of August 8, 1973, you asked about the escalation provisions in the Navy's LHA and DD-963 contracts with Litton Industries. You asked GAO to determine the actual changes in labor costs and compare this to labor escalation payments which are being made on the basis of changes in Bureau of Labor Statistics, Department of Labor, indexes.

In our letter to you on July 21, 1972 (see enclosure), we explained the methodology the Navy and Litton used to compute escalation on the DD-963 contract. The LHA contract provisions are basically the same. Because many factors other than the changes in the indexes are to be considered, we believe that a comparison of increases in actual labor costs with increased payments to Litton resulting from these changes may not produce meaningful results.

METHODOLOGY OF COMPUTING ESCALATION

These fixed-price incentive contracts state that, regardless of actual changes in the cost of labor or materials during the performance of the contracts, adjustments for escalation will be made in accordance with specific contract provisions for labor and material compensation adjustments.

Each contract specifies a percent of initial target cost which constitutes the labor cost subject to adjustment for escalation and a percent which constitutes material cost subject to adjustment for escalation. Each contains tables showing how labor cost is apportioned over the life of the contract and the percent of target cost subject to adjustment for changes in labor cost apportioned to each

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quarterly period. The amount of the escalation adjustment is determined quarterly by applying actual labor and material indexes provided by the Bureau of Labor Statistics (BLS).

Several factors other than the index itself come in for consideration in calculating escalation compensation. Further, it is highly probable that none of these elements-- percent of cost subject to adjustment and quarterly apportionments--are in fact occurring precisely as predicted before the contract was awarded.

BLS INDEXES

The indexes used are national labor and material indexes. The labor index represents the monthly change in the straight-time average hourly earnings for selected shipyards, and the material index represents a weighted selection from the BLS Wholesale Price Index. As such, they are averages and not necessarily applicable to any specific geographical location.

ESCALATION CLAUSE IN COMPETITIVE SHIPBUILDING AWARDS

The clause used in the LHA and DD-963 contracts is a standard clause written so that the low bid in competitive procurements can be determined. It is not peculiar to the two contracts in question.

C2 The maximum amount of escalation adjustment recoverable over the life of the DD-963 contract was a primary factor in determining the low bid and award of the contract. The competing contractors, in their bids, projected labor and material indexes to the end of the contract. In an August 26, 1970, report to Senator Margaret Chase Smith, we pointed out that Litton's winning bid was based on an escalation adjustment totaling \$143.7 million more than the costs it would incur over the life of the contract. Our letter indicated that Litton made reductions in its proposed material costs in recognition of the expected overrecovery.

SUMMARY

In summary, we believe it would be of little value to attempt to compare actual labor cost increases with those allowed under the contracts. As pointed out:

1. The indexes used are only one factor in calculating the reimbursements. The cost base subject to escalation and the distribution of the base between labor and material had to be specified as well as the time phasing of the escalation bases.
2. The contract was negotiated in a competitive situation and the potential contractors bid on the same escalation basis.

A subsequent comparison of incurred costs with costs included in the contract price for just one element of cost could be misinterpreted or accidentally misused, to the detriment of the competitive negotiation process.

The escalation provisions in contracts of this type are intended to minimize the risk to both the contractor and the procuring agency for economic conditions over which they have no control. The methodology for accomplishing this must necessarily rely on averages and projections of labor and material use several years in the future. Although it is true that a contractor could be reimbursed more than its actual incurred cost, the contractor could also be reimbursed less, depending on the performance of the indexes and the elements of cost in its bid.

Sincerely yours,



Comptroller General
of the United States

Enclosure